MONETARY SOVEREIGNTY: BEYOND THE MANTRA

The debate on monetary sovereignty in emerging countries is resurfacing with, on the one hand, the plan of Argentinian President Javier Milei to dollarise his economy, and on the other, the temptation of several West African country leaders to abandon the CFA franc. From a strictly economic point of view, dollarisation is effective in tackling hyperinflation. However, to be sustainable in the long term, it imposes severe constraints on fiscal policy and the nature of foreign investment. Conversely, the abandonment of the CFA franc with the aim of recovering the flexibility of an unpegged exchange rate regime and greater autonomy of monetary policy, is an argument that is either weak in theory or unconvincing in practice, even in the short term.

AMONETARY SOVEREIGNTY AND FOREIGN EXCHANGE SOVEREIGNTY: TWO SIDES OF THE SAME COIN

The debate on monetary sovereignty is resurfacing, with on the one hand, the plan of Argentinian President Javier Milei to dollarise his economy, and on the other, the temptation of several West African country leaders to abandon the CFA franc. Admittedly, the motives are very different in nature; in the case of Argentina, they are purely economic and circumstantial, with simple replacement of the peso by the US dollar being, according to Javier Milei, the only way to radically and sustainably fight out-of-control inflation that had reached 288% over a year in March.[1] Secondly, the motive is political and based on the sovereign principle that currency is a government attribute that cannot be delegated to another country. In the case of the CFA franc, delegation takes the form of a fixed parity versus the euro and a convertibility guarantee provided by the French Treasury.

From an economic perspective, monetary sovereignty is not limited to delegation of the exchange rate. It implies monetary policy freedom, i.e., the free choice for a central bank to raise or lower its key interest rate, or to increase or reduce its balance sheet (quantitative policy).

Unfortunately, the choice of currency regime constrains monetary policy; a fixed currency regime requires the central bank to intervene to avoid permanent deviation of its key policy rate from the key rate of the central bank of the country of the anchor currency, or to refrain from implementing a quantitative policy that would lead to a lasting divergence in money market interest rates.

The choice of currency regime may also constrain budgetary policy; in the case of a currency board regime and, even more so, dollarisation, balanced public accounts are a necessary condition to ensure the credibility of fixed parity.[2]

In the past, use of dollarisation or a currency board has proven effective in dampening soaring inflation in the early years of implementation (Argentina in 1991, Bulgaria in 1997, Ecuador in 2000). The challenge, once inflation is under control, is to maintain fiscal discipline and attract productive foreign investment, in order to credibly build disinflation and ensure economic growth over the long term.

REAL EFFECTIVE EXCHANGE RATE OF THE WAEMU AREA

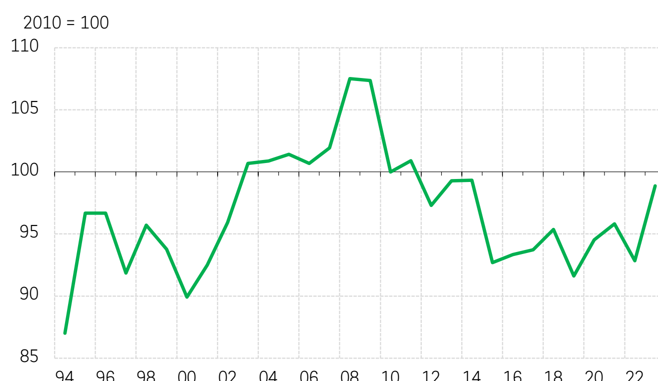

CHART 1 SOURCE: ALI ZAFAR, WAEMU, BNP PARIBAS

Therefore, although particularly brutal from a social point of view, Javier Milei's strategy (aimed at generating a primary budget surplus and removing capital control as quickly as possible) is consistent with the dollarisation plan from an economic point of view.[3] And even though the central bank (BCRA) has cut its key rate since mid-December (from 133% to 70% currently), the aim of the new authorities is not to hope for a recovery in growth through credit. They are simply looking for an urgent way to alleviate the increasing public finance cost of the sterilisation operations carried out by the BCRA to contain the inflationary effect of the monetary financing of the budget deficit. Monetary policy will remain very significantly constrained by inflation.

ABANDONING EXCHANGE RATE PEGGING: UNCONVINCING ECONOMIC ARGUMENTS IN THE CASE OF THE FRANC ZONE

Abandoning the peg of the CFA franc raises more questions. The primary, and never-ending, argument is that the conditions for an optimal currency area (OCA) would not be met. However, meeting all these conditions is so restrictive that this argument has a very limited practical scope.[4] Conversely, there are two interesting arguments to be discussed: the alleged overvaluation of the CFA franc and the

1 In fact, inflation accelerated mainly due to the 54% devaluation of the peso against the USD on 13/12/2023 (to reduce excess demand for dollars and not to rebalance external accounts) and the removal of subsidies. But the inflationary drift was well-established before that.
2 Except in the quite rare scenario in which the private sector has a structural financing capacity or, in more usual scenarios, in which the current deficit is covered by foreign direct investment (FDI) or sources of debt financing for projects generating sufficient foreign currency revenue to stabilise the current deficit at a low level. However, in these two scenarios, the use of a currency board is not necessary when choosing the exchange regime since, in order to attract FDI or hard currency-generating investments, the recipient country must have macro-financial stability and therefore, a moderate and stable level of inflation.
3 We will not be discussing here the technical feasibility of dollarisation in the Argentinian scenario; this is an important topic but not one covered in this editorial.
4 The success of the European system of central banks (as a permanent mechanism for preventing balance-of-payments crises through the role of Target accounts as a buffer and/or a one-off instrument for the rationalisation of financial resources during shocks such as Covid), is a perfect counter-example of this. We should remember that the eurozone was criticised on the basis of non-compliance with the OCA conditions, which was, incorrectly, considered to be at the origin of the sovereign debt crisis during the first part of 2010.

slowdown in growth due to the lack of monetary policy flexibility. Is this really the case?

Observation of the real exchange rate of WAEMU countries over a long period, shows an appreciation of 10% compared to 1994 (year of devaluation), but with three sub-periods: a trend appreciation between 1994 and 2009, then a trend depreciation between 2009 and 2018, and a stabilisation since then. We cannot therefore talk about a clear overvaluation, either in terms of level or in terms of dynamics. Moreover, the BCEAO's foreign exchange reserves have not reached a critical level, as was the case in 1993. Although they have dwindled since 2021, they are still above their statutory limit of 20% of the BCEAO's external commitments, compared to 18% at the end of 1993.

The review of overvaluation can be refined using modelling approaches. In 2021, based on its two principal external imbalance valuation models,[5] the IMF estimated, according to the method, either a slight overvaluation of the CFA franc of 2.9% (1st method) or even an undervaluation of 5.6% (2nd method). In both cases, the spread was small and the IMF concluded that the real exchange rate was in line with the zone's fundamentals. These conclusions are still valid in 2023.

By using a rudimentary general equilibrium model (GEM) but adapted to developing countries,[6] a former World Bank economist and current economic adviser to the United Nations, Ali Zafar, on the contrary, indicated in a recent book on the Franc Zone,[7] a strong overvaluation of the real exchange rate for the entire WAEMU zone, of 20%, ranging from 16% to 26% depending on country. However, as the author states, this result depends heavily on the magnitude of the shock introduced into the model to result in such an overvaluation. More specifically, using the model for Senegal, a terms-of-trade shock (ratio between international prices in dollars of exports and those of imports) of the order of 30% is required to justify an overvaluation of the order of that calculated by Ali Zafar.[8] Moreover, the terms-of-trade shock still needs to last for several years to justify a devaluation in response to the worsening of fundamental balances (budgetary and external balances) and this terms-of-trade shock still needs to not correct an exceptional improvement in previous years. However, in the case of Senegal, over the past two decades, the sharp decline, alone, of nearly 20% in cumulative terms from 2009 to 2013 had precisely followed an improvement of 35% in cumulative terms, also from 2004 to 2008.

The second argument (lack of monetary policy flexibility) seems even less well-founded. In real terms, credit growth in the private sector of the WAEMU was very rarely less than 10% p.a. between 2013 and 2019 (compared with real GDP growth of 6% p.a. on average). Credit growth slowed in 2020-2021, as in most countries, but accelerated again from 2022. It remained sustained in 2023, despite the ECB's monetary tightening.

WAEMU AREA: DOMESTIC BANK CREDIT TO THE PRIVATE SECTOR DEFLATED BY THE CPI INDEX

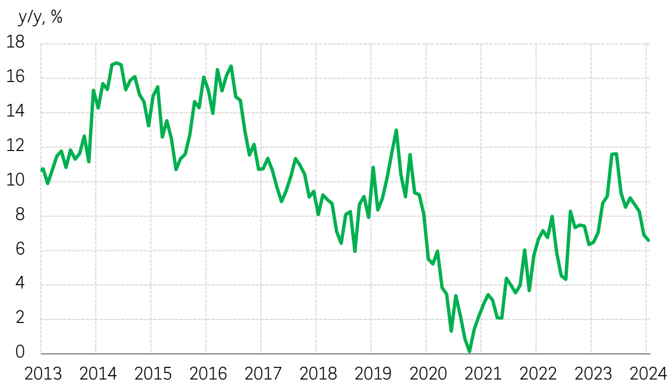

CHART 2

SOURCE: WAEMU, BNP PARIBAS

In summary, the two main economic arguments advocating for monetary sovereignty of the countries of the franc zone (flexibility of unpegged exchange rate and flexibility of monetary policy are either weak in theory (first argument) or unconvincing in practice (second argument).

One development that would make economic sense would be the abandonment of fixed parity versus the euro alone, in favour of pegging it to a basket of strong currencies more representative of the structure of foreign trade, a development that most economists, including Ali Zafar, defend. On the other hand, casting off without a probationary period of stability would be very risky in our opinion, as repayment of public and private debts might well not be possible in the event of devaluation. As politically legitimate as it may be, monetary and foreign exchange sovereignty cannot be decreed, it has to be acquired.

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5 The first method is based on a comparison between the cyclically-adjusted current balance, and exceptional factors (e.g. imports of capital goods required for a major investment project) with a reference value (norm). This value is determined based on: 1/ the coefficients of an econometric estimate over 150 countries between the current balance and a set of structural variables, (structural budget balance, productivity, demographic variables, political and institutional environment, etc.) 2/ the values of these variables for the country in question. The difference between the cyclically-adjusted current balance and the norm, if any, makes it possible, using a standard elasticity of the current balance at the real exchange rate, to calculate the (real) exchange rate gap (misalignment) that would make it possible to close the current balance gap. Indirectly, the real exchange rate is judged as overvalued or undervalued. The other method works in reverse; it consists of estimating the equilibrium exchange rate (also based on structural determinants), directly deducting the misalignment and indirectly the current balance gap.
6 S. Devarajan, D.S. Go, J.D. Lewis, S. Robinson & P. Sinko "Simple General Equilibrium Modeling" in Applied Methods for Trade Policy Analysis - Cambridge University Press - 1997.
7 Ali Zafar: "The CFA Franc Zone - Economic Development & the Post-Covid Recovery" - Palgrave McMillan - 2021.
8 In the GEM of Devarajan et al., the exchange rate is fixed, so that in a situation of terms-of-trade shocks, a drop in the price of domestic goods (and therefore a real depreciation of the exchange rate) is necessary to leave the trade balance stable thanks to the substitution between domestic goods and equivalent imports on the one hand, and the transfer of production from domestic goods to exports on the other. The resulting conclusion, that a (real) devaluation would be a remedy for terms-of-trade shock, is only valid if the elasticity of substitution between imports and domestic goods is less than 1, which is, in theory, the case for emerging and developing countries. In other words, the negative income effect of a terms-of-trade shock (loss of purchasing power) outweighs the substitution effect and leads to a contraction in imports. In the meantime, the increase in the relative price of exports compared to the price of domestic goods results in an increase in exports due to the transformation of the production of domestic goods to exports (assuming an elasticity of transformation less than 1 in the case of emerging and developing countries).